EXECUTIVE CHAMBERS

HONOLULU

BENJAMIN J. CAYETANO
GOVERNOR

July 13, 1998

The Honorable Norman Mizuguchi, President
and Members of the Senate
Nineteenth State Legislature
State Capitol, Room 003
Honolulu, Hawaii 96813

Dear Mr. President and Members of the Senate:

This is to inform you that on July 10, 1998, the following bill was signed into law:

H.B. 2749 HD1, SD1, CD1 RELATING TO TAXATION (ACT 157)

With warmest personal regards,

Aloha,

Benjamin J. Cayetano

BENJAMIN J. CAYETANO

Economic Revitalization Income Tax/ General Excise Tax Proposals

Comparative Analysis of Governor's Revisin to ERT-14, S.B. No. 2259, S.D. 1, H.D. 1 & H.B. No. 2749, H.D. 1, S.D. 1*

Department of Taxation

April 17, 1998

Provision	Governor's Revision to ERT-14	S.B. No. 2259, S.D. 1, H.D. 1	H.B. No. 2749, H.D. 1, S.D. 1
I. Individual Income Tax			
Rates and brackets 235-51 Standard deduction 235-2.4	• 4 new upper income brackets, top rate reduced to 7.5% by year 3 • 30 percent reduction in Year 1&2; 40 percent reduction in Year 3 for joint filers below $41K Year 1&2 / Year 3 Not over $3K: 1.40% / 1.20% Over $3K not over $5K: 2.80% / 2.40% Over $5K not over $7K: 4.20% / 3.60% Over $7K not over $11K: 5.08% / 4.35% Over $11K not over $21K: 5.60% / 4.80% Over $21K not over $31K: 6.13% / 5.25% Over $31K not over $41K: 6.65% / 5.70% Over $41K not over $60K: 7.00% / 6.00% Over $60K not over $80K: 7.50% / 6.50% Over $80K not over $100K: 8.00% / 7.00% Over $100K: 8.50% / 7.50% Capital gains cap rate reduced 5.08% / 4.35% **Revenue Impact:** **Year 1 & 2** / **Year 3** **Loss** **($273 mill)** / **($373 mill)**	• 4 new upper income brackets, top rate reduced to 8.0% by year 3 • 25 percent reduction in Year 1&2; 35 percent reduction in Year 3 for joint filers below $41K Year 1&2 / Year 3 Not over $3K: 1.50% / 1.30% Over $3K not over $5K: 3.00% / 2.60% Over $5K not over $7K: 4.50% / 3.90% Over $7K not over $11K: 5.44% / 4.72% Over $11K not over $21K: 6.00% / 5.20% Over $21K not over $31K: 6.57% / 5.69% Over $31K not over $41K: 7.13% / 6.18% Over $41K not over $60K: 7.50% / 6.50% Over $60K not over $80K: 7.85% / 7.00% Over $80K not over $100K: 8.20% / 7.50% Over $100K: 8.50% / 8.00% Capital gains cap rate reduced 5.44% / 4.71% **Revenue Impact:** **Year 1 & 2** / **Year 3** **Loss** **($229 mill)** / **($323 mill)**	• Income brackets restructured, top rate reduced to 9.0% by Year 3 • Standard deduction amounts increased Joint / Head of Household / Single / Mar[illegible] filing se[illegible] from $1,900 / $1,650 / $1,500 / $[illegible] to $3,000 / $2,800 / $2,500 / $1[illegible] Year 1&2 / Year [illegible] Not over $5K: 2.0% / 1.50% Over $5K not over $10K: 4.5% / 4.00% Over $10K not over $20K: 6.5% / 6.00% Over $20K not over $30K: 7.5% / 7.25% Over $30K not over $50K: 8.5% / 8.25% Over $50K not over $80K: 9.0% / 8.75% Over $80K: 9.5% / 9.00% Capital gains cap rate reduced n.a. / 6.5% **Revenue Impact:** **Year 1 & 2** / **Year 3** **Loss** **($153 mill)** / **($201 mill[illegible]**
Effective date	• *Applies to taxable years beginning after 12/31/98 (12/31/00 for Year 3)* • *Individuals whose taxable year includes effective date use a designated weighted average tax rate*	*Same*	*Same*

* H.B. No. 2655, H.D. 1, S.D. 1 contains the Senate response to the House version of ERT-1(H.B. No. 2554/ S.B. No. 2201 and ERT-1A (H.B. No. 2552/ S.B. No. 2202)

COPY

PN

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DEPARTMENT OF TAXATION
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April 17, 1998

COMMENTS ON H.B. NO. 2749, H.D. 1, S.D. 1
RELATING TO TAXATION

The Department of Taxation (Department) presents the following information and comments regarding H.B. No. 2749, H.D. 1, S.D. 1. This bill previously contained language that would have subjected certain travel agents, taxicab drivers, and real estate agents to the general excise tax at an unspecified rate. Those contents were deleted and the Senate inserted its response to the ERTF income and general excise tax proposals, and added other miscellaneous tax measures as well.

Overview of Senate's Response to ERTF Tax Proposals

Individual Income Tax Provisions

The individual income tax provisions apply to taxable years beginning after December 31, 1998, and contain the following features:

1. Section 7 of the bill expands the income brackets with the highest rate applicable to taxable income over $80,000. The top income tax rate is reduced to 9½% in Year 1 and 2, and to 9% in Year 3 of implementation. It also reduces the capital gains rate cap from 7.25% to 6.5% for taxable years beginning after December 31, 2000.

2. Section 4 of the bill increases the standard deduction by amounts ranging from 60% (joint filers, married filing separately) to 70% (head of household), as follows:

Filing Status	State	Federal	Proposed
Joint filers	$1,900	$6,900	$3,000
Head of household	$1,650	$6,050	$2,800
Single	$1,500	$4,150	$2,500
Married filing separately	$950	$3450	$1,500

3. Section 7 of the bill creates a new refundable excise tax credit; maximum of $55-per-exemption and minimum of $35-per-exemption. The credit phases out for taxpayers with adjusted gross incomes of

$30,000 or more. The refundable $27-per-exemption food tax credit is retained. No double exemptions may be claimed for age.

Comment: The Department prefers the approach taken by the House in S.B. No. 2259, S.D. 1, H.D. 1 (House version) which offers greater income tax rate relief and partially offsets the revenue loss by increasing the general excise tax by 0.5%. That bill more closely follows the Governor's bold ERTF tax proposals. The income tax proposals offered by H.B. No. 2749, H.D. 1, S.D. 1 do not lower the income tax rates enough to make an impact on investors to encourage the capital inflow that Hawaii sorely needs. Currently, Hawaii ranks as the state with the third highest income tax rates. Under the House version, the highest marginal rate would be 8% in Year 3 and would drop Hawaii's ranking to thirteenth highest, while the Senate version would drop us to only to eighth place (with a top rate of 9%). The House's version brings Hawaii's top rate closer to the national median of 7%.

SCR No. 3296 provides an example of tax burden for a joint return with two people at various levels of Adjusted Gross Income (AGI) and illustrates that the amended brackets and rates, increased standard deduction, new low-income tax credit and existing food tax credit increase the progressivity of the income tax structure. While a more progressive tax structure is a desirable social feature, it is questionable whether the smaller reduction in rates would create the economic incentives needed for the goal of attracting business and investment to the state. Moreover, the Senate version contributes little to structural change which would shift taxation away from income and production to consumption and increase the rate of return on investment. The House version better accomplishes this with its more significant income tax cut and partially offsetting general excise tax increase.

General Excise Tax Exemption for Exported Services

The general excise tax provisions apply to gross proceeds received after December 31, 1998 and thereafter.

1. Section 12 of the bill exempts from general excise tax services exported to an out-of-state customer. This provision is similar to the Governor's proposed exemption except that under this bill: (a) the out-of-state customer must be "unlicensed" for general excise tax purposes; and (b) the Department may require a certificate from the out-of-state customer certifying that the service purchased will be resold or consumed outside of Hawaii, but the purchaser is not obligated to pay the seller additional general excise tax if the service is not in fact used out-of-state.

Comment: The Department concurs with the exemption for exported services, but prefers the language of the House version. The provision which would obligate the buyer to pay the seller additional tax if the service is not used outside the State should be included. Since the general excise tax exemption is granted to the seller of exported services, the burden of the tax falls back on the seller if the service is not exported. Therefore, the export service exemption should add, on page 32, line 18:

"Any purchaser who furnishes this certificate (or an equivalent specified by the department) shall be obligated to pay the seller or person rendering the services, upon demand, if the service purchased is not resold or otherwise consumed or used outside the State, the amount of the

additional tax which by reason thereof is imposed upon the seller or person rendering the service."

2. Section 13 of the bill repeals the exemption for certain computer services exported out-of-state as it is duplicative of the new exported services exemption (services which are performed in Hawaii, but consumed outside of the State).

Use Tax Imposition on Imported Services

The use tax provisions take effect on January 1, 1999 and apply to all taxes accruing after December 31, 1998 and thereafter. A similar provision is contained in the Governor's and House versions.

1. Section 16 of the bill allows the Department to require that the Hawaii service user obtain from the seller a certificate certifying that the seller is "not an unlicensed seller" (i.e., a licensed seller) and therefore the user is not subject to the use tax with respect to the services sold. In the absence of a certificate, there is a presumption that the seller is unlicensed and the Hawaii user is subject to use taxation on the value of the services imported. If the seller is licensed, the seller is liable for general excise tax on the sale of the service.

2. Section 17 of the bill adds definitions for "foreign customer" and "services" for the purpose of interpreting the new use tax imposed on imported services. Other definitions in section 238-1, HRS, are amended to provide for the imposition of a use tax on imported services. Hawaii service importers are exempt from the use tax when the service is resold to a "foreign customer," meaning a nonresident who has not been present in the State for more than 30 consecutive days in the six-month period prior to entering into a written export agreement with a licensed person in Hawaii. This exemption is intended to encourage packaging of services in Hawaii and provides an incentive for such activities to occur here.

3. Section 18 of the bill imposes a use tax on services imported into the State. The rates are imposed at two rates upon the value of the service: ½% if the importer of the service acts as an intermediary between the seller and the ultimate recipient of the service; and 4% in all other cases.

Comment:

(a) For clarity, the term "out-of-state customer" should be substituted for the term "foreign customer" on Page 35, line 1. Reference to a "foreign customer" also appears on page 40, line 18.

(b) With regard to imposition of the use tax on imported services, the service definition should explicitly include professions, particularly because professions are referenced in the proposed general excise tax exemption of exported services. Page 35, line 13 should read, "...business or calling, the practice of a profession, or other business for other persons for a..."

(c) No tax revenues would be collected as there would be an exemption on the service coming into the State and upon its exit from the State. At the very least, the service importer should be liable for ½% of the value of the service imported and re-exported. Complete exemptions for economic development reasons should be carefully examined.

(d) To clarify determination of the value qualifying for the 1/2% rate applicable when a Hawaii purchaser of a service produced out-of-state acts as an intermediary between the seller and the ultimate beneficiary of the service, page 44, line 6 should read, " ...services [actually received] resold by the purchaser or importer..."

Miscellaneous Tax Measures

In addition to the tax restructuring proposals discussed above, the Senate inserted the contents of the following other tax measures.

1. Section 3 of the bill inserts the contents of H.B. No. 3041 which allows nonresident shareholders/members of pass-through entities to elect to file composite returns at the highest marginal rate applicable to individuals.

Comment: We support this measure as it expands on an administration bill that facilitates filings by nonresidents. The prefatory language to Section 3 of the bill should read "Chapter 235, Hawaii Revised Statutes, is amended by adding a new section to Part VI to be appropriately designated and to read as follows:" The effective date for this provision in Section 10 of the bill should apply to taxable years beginning after December 31, 1996 which corresponds to the original enactment of Act 281, SLH 1997.

2. Section 4 of the bill inserts the contents of S.B. No. 2450 which increases the income tax deduction for meals and entertainment from 50% to 80%.

Comment: This provision brings Hawaii tax law out of conformance with the Internal Revenue Code which makes for complexity. Further, there is no measurable or predictable positive economic benefit that will accompany the increased deduction; it is a mere give-away of State revenue. The small marginal benefit for State tax relief without a corresponding federal increase in the deduction, provides no incentive for increasing the meal and entertainment deduction at the state level.

3. Section 5 of the bill inserts the contents of H.B. No. 3038 which removes potentially unconstitutional requirements to receive the state's income tax deduction for dividends received by a corporation. We support this administration measure that will bring more capital into Hawaii.

Comment: On page 12, line 11, the "and" should be replaced with "or" to clarify that the taxpayer may not claim both the 100% and 70% deduction. On page 12, line 23, the "and" should be changed to "or" to clarify that the taxpayer need only meet the 95% requirement or the bank/insurance company requirement. The effective date for this provision in Section 10 of the bill should apply to

taxable years beginning after December 31, 1996 to ensure taxpayers are given full benefit of the 70% deduction.

4. Section 6 of the bill inserts the contents of S.B. No. 2092 which extends the income tax energy credit to July 1, 2003. Deletes requirement that a licensed professional engineer provide written opinion to the effect that solar energy system provides not less than 80% of hot water needs for all occupants of a multibuilding unit primarily used for residential purposes.

Comment: The Governor has only agreed to sign a bill to extend the credit if it is reduced from 35% to 20%. The credit has only encouraged the industry's dependence on governmental subsidies; tax credits should be used to encourage new industries and should not be thought of as entitlements.

5. Section 24 of the bill inserts the contents of H.B. No. 3037, H.D. 1 which partially phases out the tax exemptions allowed to Business Development Corporations (BDCs) that fulfill the purposes and requirements of chapter 420, HRS. We support the enactment of this measure provided that the technical problem discussed below is resolved.

Comment: Due to an apparent drafting error, the tax exemption phases down to 20% instead of phasing out completely. To stop the tax leakage and abuse of chapter 420, HRS, the exemptions need to phased out completely. We recommend a technical amendment to section 1, page 4, adding paragraph (8) to read as follows:

> "(8) For the taxable year beginning in 2005, and thereafter, the tax exemption or credit allowable shall be zero. Any tax exemption or credit not used shall not be applied to future tax years."

There are also no transitional rules for "BDCs" that do not meet the purposes and requirements of chapter 420, HRS. We recommend that the bill provide that BDCs that do not meet the requirement of chapter 420, HRS, revert to C corporations.

Respectfully submitted,

RAY K. KAMIKAWA
Director of Taxation

Encl.: Comparative Analysis

Stanley Hong - Chamber of Commerce
Stephanie Sofos - Sofos Realty

I am proud to sign legislation giving Hawaii taxpayers a $759 million personal income tax cut.

This tax cut will help the economy grow by putting money into people's pockets.

Every taxpayer will pay less taxes -- families, single people, single parents, and senior citizens.

For a state our size, Hawaii taxpayers are getting the biggest tax cut in the nation -- and one of the biggest income tax cuts given by any state in the nation since 1993.

This is a bold and historic income tax cut -- not just one year -- but each of the next 4 years.

In the last 5 years, only 10 states have cut personal income taxes more than Hawaii.

In 7 of those states, the Governor was a Republican.

And when you compare total tax cuts -- Hawaii ranks high. Only 16 states cut all taxes more than Hawaii.

This information is based on reports from the National Conference of State Legislatures.